



Discussion Paper on Funding and Financing Infrastructure in Victoria

Purpose

This paper provides a discussion of two issues: the rate of expenditure on infrastructure in Victoria and impediments to the use of private sector finance.

Background

Victoria's infrastructure requirements are well-documented. There are urgent requirements in freight and passenger transport and social infrastructure in growth corridors. Together, State and local government are searching for the means to provide this infrastructure. The State government, and to a lesser extent local government, is investing in infrastructure but the rate has lagged behind the requirement.

The detriment of inadequate investment in infrastructure is also well-documented, specifically the constraints on economic activity, lower productivity and competitiveness, reduced amenity for users, and declining social equity. Rather than conserving resources, low levels of investment impose substantial costs and ultimately Victoria's economy will be smaller than it otherwise would be. Delaying investment in the legacy stock also introduces higher whole of life costs because assets need to be intensively maintained or renewed to extend their useful lives.

Funding and Finance – No Magic Pudding

The distinction between finance and funding needs to be clear: a funding source must be present to support finance. This is a critical point because the availability of capital or financial products does not obviate the funding requirement. There is no magic pudding. While there are specific issues – and opportunities – with funding and finance, they are not the same. Accordingly, this paper addresses the need for change and innovation in both funding and finance.

Funding

Funding for infrastructure in Victoria is ultimately sourced from the community. Funding can be sourced directly from users of infrastructure or indirectly through taxes and charges (or rates for local government). The willingness of government and users to commit funds ultimately determines the level and pace of development, and this is discussed below.

Inadequate Expenditure

It is difficult to estimate the right level of expenditure on infrastructure and difficult to measure the performance of the existing stock of infrastructure. This is because expectations and preferences differ across the community, and as a result, assessments are subjective. However, there is a consensus view that over the last two decades the level of expenditure on new and existing infrastructure has been too low. There is anecdotal evidence of demand for higher levels of amenity from infrastructure across sectors such as transport, health, education, energy and water, and recreation. This evidence suggests that increasing expenditure to augment the current stock is the preference of most in the community. Engineers Australia has argued that “critical aspects of Victoria’s infrastructure are barely adequate for current needs” and that “funding commitments are largely inadequate to support...renewal and replacement.”¹

The medium-term fiscal strategy in the 2013 budget commits to infrastructure spending of 1.3 per cent of gross state product (GSP) as a five year rolling average. Nominal GSP in 2013 is forecast to be \$340 billion, suggesting a commitment of approximately \$4.5 billion per annum.

Shift to User Pays

The expenditure required for some types of infrastructure can be sourced directly from users, either wholly or in part. A direct relationship between providers and users offers scope for infrastructure to be provided solely by the private sector or through concession-type arrangements. Energy assets are an example of the former and toll roads an example of the latter. In Australia, direct user charging is limited and governments have taken a conservative approach to introducing new user charging regimes. This is in part a cultural issue with origins in the post-war welfare state, and its principle of social equity through universal access. However, a legacy of this culture is a lack of understanding in the community of the costs of infrastructure and an absence of price signals to shape behaviour by users. As a result, it is difficult for private and public sector providers of infrastructure to determine a community’s willingness to pay for different services and levels of amenity, which is inherently inefficient.

There are opportunities to extend user charging and the visibility of costs and benefits more generally. This could generate a cultural shift to using price signalling to drive behaviour. Public transport is an obvious example of the tension between user charging and government funding, and of the potential to induce changes in behaviour by introducing mechanisms which lead to users to pay for the benefits they derive and the costs they impose. There are other examples in the education, health and waste sectors. Aside from changing demand profiles, there would be greater opportunities to deploy private sector finance to new projects without substantive public sector financial support. However, while a shift toward price signalling is desirable, it will be important to address the impact of change on social equity, or in other words, to recognise the cost of achieving social outcomes. There is likely to be scope to transplant the equity embedded in the taxation system to mechanisms of user charging, and this would support governments selling the approach to the community.

¹ Engineers Australia: *Infrastructure Report Card 2010 Victoria*, February 2010

In addition to direct user charging, there are opportunities to extract the expenditure required for infrastructure from other beneficiaries of it. This approach is similarly based on the principle that those who benefit from infrastructure should contribute to its cost. For example, direct charges from network users, who benefit from infrastructure indirectly, or levies on private parties who capture a portion of the value created by infrastructure through higher property or other commercial values.

Efficient Expenditure

The State should continue to focus on minimising the process and administrative costs associated with deploying a given amount of expenditure on infrastructure. Victoria has implemented a range of initiatives in this area, such as the Gateway process, and continuing to pioneer and support them is essential. In this regard, the Public Accounts and Estimates Committee are examining the 'integral need for public sector managers overseeing significant infrastructure projects to possess appropriate skills and expertise' and will report in December.²

Financing

Infrastructure can be financed by the public or private sector. A brief discussion of salient issues is below. It is important to acknowledge that the weight of finance, even if mobilised for infrastructure, is alone not a solution to the infrastructure backlog. The community, through users, beneficiaries or government, must be willing to allocate enough expenditure to pay for projects.

Public Sector Financing

Over the last two decades, the state (and federal) government have relied on surplus recurrent revenues to finance their expenditure on infrastructure. They have actively minimised the use of debt. This approach has reflected a short term focus on generating cyclical budget surpluses and maintaining credit ratings. It is important to recognise that this approach is driven by political imperatives rather than sound economics. Many commentators in the infrastructure debate have pointed to the weaknesses of the approach, which has the effect of prioritising short term financial considerations over long term economic outcomes. It has deferred projects which offer net economic benefits and which could expand long run economic capacity. Government in Victoria (and elsewhere) has the balance wrong and there is a role for advocates to deliver this message. Governments should place more emphasis on structural surpluses over the economic cycle.

The recent approach to fiscal policy has entrenched an aversion to debt, and perception that only very low (and shrinking) debt levels are sustainable. As noted by many commentators, debt funding avoids the need to wait for surpluses and equitably spreads the cost of long-life infrastructure across generations. Victoria's balance sheet is strong by any measure: specifically, it has a very low debt to GSP ratio (6.5% in FY 2012), which is a primary measure of its capacity to repay debt. Governments need to move away from debt aversion and achieve a more sensible balance between revenues and debt. Some have proposed debt raisings 'for-infrastructure-only' as a way to support governments to sell this message to the community.

² Parliament of Victoria: Public Accounts and Estimates Committee. Inquiry into Effective Decision Making for the Successful Delivery of Significant Infrastructure Projects. Terms of Reference received from the Legislative Assembly on 5 May 2011.

- In FY 2013, Victoria will spend approximately \$1.7 billion servicing debt and finance lease costs.

There is a role for advocates to encourage the Victorian Government to target a sustainable level of debt over the medium term, even if it is not consistent with a stable AAA debt rating. (In most scenarios, it is very likely to be consistent.) It is important to note that foregoing investment in economically productive infrastructure to preserve finances today risks degrading our productive capacity and social capital in the long run, which increases our vulnerability to external shocks. Private sector investors, including superannuation funds, strongly support expanding long-term government borrowing to fund infrastructure, for reasons of equity and certainty.

Private Sector Financing

There is a long history of private sector financing of infrastructure in Victoria. Private investors have demonstrated a willingness to participate in a wide range of financing solutions in respect of government infrastructure including build-own-operate-transfer projects, availability-based social infrastructure projects, and the privatisation of public sector assets and businesses.

However, the Global Financial Crisis (GFC) reduced the depth and appetite of the financing market, and it has not fully recovered. The crisis was a catalyst for the investigation, and in some cases the use, of innovative financing solutions and hybrid financing models, which enhanced Australia's reputation as a mature and sophisticated infrastructure market. The private sector, though slimmer, continues to be hungry for infrastructure transactions. However, a range of issues persist in the market which are impeding to a degree their rate of participation, efficiency of offering, and breadth of innovation. These issues are discussed below.

Encouraging Superannuation

Many politicians and commentators have suggested that superannuation funds should increase their participation in financing infrastructure. They point to the weight of funds under management and the match between long run investment horizons and long-life infrastructure. While this alignment does exist to an extent, there are other complex issues which need to be recognised, and which are discussed below.

In-house Skills

Infrastructure as an asset class is highly complex and requires specialised skills to carry out commercial, financial and tax due diligence prior to making investment decisions. The shortage of specialist expertise has been cited in recent years as a barrier to investment in infrastructure by superannuation funds. Although superannuation funds often use specialist asset consultants, they still require a certain level of in-house commercial understanding from the fund managers through to trustees. A number of superannuation funds are addressing this concern by increasing the skill level of in-house resources. However, as noted by Infrastructure Partnerships Australia, superannuation funds will only be motivated to retain in-house infrastructure expertise and move away from using consultants if there is a functional and transparent infrastructure market.

The more significant impediments to increased participation by superannuation funds are:

- the lack of clear pipeline and funding commitment; and
- the lack of suitably structured projects.

No Clear Pipeline

The infrastructure industry continues to call for a committed and stable pipeline of infrastructure projects. However, governments, including in Victoria, have not provided a clear and committed pipeline beyond the short term. Long-term policy intent across portfolios is typically non-committal on the scope and timing of major projects, meaning current guidance is often treated as a 'wishlist' rather than a genuine programme for procurement and delivery. Superannuation fund managers express the view that inadequate planning by government as sponsor, combined with poor integration between state and federal planning and approval processes, leads to an unacceptable level of risk regarding the commitment to, and timing of, government sponsored projects. This complicates their decision to invest in resources to finance projects.

The lack of a pipeline is exacerbated by political risks and the vagaries of the electoral cycle. That is, a lack of clarity about the timing of projects and in other states the cancellation of large projects during the procurement process. This has increased the level of uncertainty with respect to government commitments and future projects. A related issue is a lack of clarity over long term policy frameworks, such as the implementation of carbon pricing.

Lack of Suitably Structured Projects

Superannuation funds invest for the benefit of their members and aim to earn a return commensurate with their assessment of risk. However, infrastructure project risk profiles are not necessarily designed to encourage institutional investment. In particular, 'greenfield' demand risk is a concern given some recent project outcomes and many funds are not prepared to accept it. Funds will consider design and construction risks but their appetite for it depends on the availability of construction entities with the skills and financial capacity to manage bespoke project risks.

The size of projects can also be a barrier. Superannuation funds have an optimal investment size range. Projects requiring an equity investment of less than \$100m – which implies a total project cost nearing \$1 billion – can result in a forecast net return, after costs, which does not justify participation. This is because transaction costs only reduce in proportion to project size to a point.

It is recognised that the solutions to these issues are beyond the capacity of one state. However, as a leading procurer of infrastructure using private finance, Victoria can set a trend.

- Victoria could contribute to a long run pipeline of funded projects, by building on the existing Infrastructure Australia priority project list.
- Victoria could work more closely with the private sector to develop structures more conducive to attracting institutional investment. For example, investigating sharing demand risk for toll road projects.

Taxation Issues

The availability of a tax-efficient collective investment vehicle, which allows the pooling of superannuation funds to share due diligence costs, is an important issue. The recent introduction of the managed investment trust regime has been significant in facilitating such collective investment. However, restrictions on the availability of flow-through treatment of trusts owning infrastructure assets and the absence of a vehicle which provides for full flow-through of income and losses remains an impediment to collective investment. The related measures announced in the 2011 federal budget addressed this issue to an extent but are highly targeted and will impact on their effectiveness.

There are other important issues, such as the illiquidity of assets and the constraints of investment mandates and asset allocations, which also impact on the propensity of superannuation funds to invest in infrastructure. These issues are discussed in other reports in the public domain.

Opportunities to Attract other Participants

There are other sources of capital which could be targeted more aggressively and which would complement the pool of capital held in local superannuation funds. They are discussed below. Attracting them is likely to be beyond the capacity of Victoria alone, but it could assume a role as an advocate for action on a national basis.

Infrastructure Bonds

While the bank debt financing market has survived the GFC, the capital (or bond) market was a casualty and remains dormant. This has stimulated discussion about an infrastructure bond market. A liquid and tradeable product such as a bond, which would be issued for particular projects, would improve the liquidity of infrastructure assets for private sector institutional investors. A new infrastructure bond market could be directed to creating incentives for superannuation funds or foreign investors to fill the current gap between senior debt (typically provided by banks) and equity. Bonds could potentially be packaged for the retail market to attract self managed funds, though the product would need to demonstrate sufficient liquidity, noting the pressure for redemptions from the unlisted retail property sector during the GFC.

However, establishing an active market or tradeable infrastructure bonds is currently impeded by:

- the relatively short terms of government-issued debt in Australia; and
- the widespread downgrading of monoline insurers and as a result the capacity to 'wrap' (or enhance the creditworthiness) of bond issues.

Some have suggested preferential tax treatment for new infrastructure bonds, but this requires caution. In principle, preferential treatment should only be sought if it will:

- attract new investors who would not otherwise participate
- improve the overall efficiency of financing by providing a cheaper solution.

Mechanisms and resources for oversight of tax-preferred arrangements are also required, to monitor up-take and costs compared with objectives. Previous attempts with tax-preferred products have resulted in poor outcomes.

Infrastructure Funds

Wholesale infrastructure funds play an important role in channelling capital from local and offshore investors into infrastructure projects. The wholesale funds range from providers of long term 'patient' capital to shorter term private equity funds. Investors in these funds include pension funds and sovereign wealth funds with an appetite for the sector but lacking the expertise to invest directly. Funds provide investors with risk mitigation through diversification. Specialist infrastructure investment expertise is provided by managers retained by the fund, which allows for the efficient sharing of due diligence costs across all investors in the fund. The introduction of the managed investment trust regime, including the concessional withholding-tax rates that apply to certain fund distributions, increases the potential to attract foreign investment.

Infrastructure Bank

Another pool of capital for investment in infrastructure could be achieved by establishing an 'infrastructure bank'. This approach has been widely debated in the United States and the United Kingdom. In simple terms, the bank uses public capital to leverage private sector capital. For example, both public and private sector funds are used to purchase highly-rated bonds issued by the bank. Those funds are subsequently re-invested in projects across a range of infrastructure sectors. The advantage of this approach is that it diversifies the risk exposure for individual institutional investors, such as pension funds, who are more comfortable with broad exposure to infrastructure as a class rather than exposure to individual projects.

Recycling Capital to Fund Infrastructure

The state (and federal) public sectors own a large portfolio of infrastructure and real property assets, and businesses operating in competitive or regulated environments. There are likely to be opportunities to recycle the capital invested in all of these assets, which – assuming the proceeds could be quarantined – could provide funds for new 'greenfield' projects and attract institutional investment. This approach would not require institutional investors to bear asset risks until they are operational and this risk-return profile would be attractive to the superannuation industry. This approach is common in the private sector and in the secondary market for equity interests in public private partnership (PPP) projects.

The superannuation industry has suggested that the federal Government commission a review of its operating assets to identify opportunities to sell and harvest capital. For its part, the public sector would need to carefully consider issues such as service levels, regulation and control, and policy change, as well as a robust framework for assessing value. Some transactions of this type have been poorly managed in the past.

Conclusion – What Needs to be Changed?

The GFC depleted the pool of finance but that finance remains active. Reforms could broaden the available pool of capital but supply is not a barrier to the private sector's participation in financing infrastructure in Victoria. Changing the mindset of government and the community is the substantive problem – fiscal policy and debt levels are too conservative to meet the infrastructure challenge. Changing the conversation on user charges is a related reform which could help manage demand and create opportunities for private sector financing with limited public sector support.